Financial Outlook For A Troubled Global Industry

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ABSTRACT

In early 2005, British Airways plans to start implementing its corporate restructuring plan with a sizeable layoff involved in response to the pressures from the competition at home and abroad. Virgin Atlantic, on the other hand, decided to test a unique approach towards name recognition of its airline by having its founding chair, Sir Richard Branson, participate in a Fall season TV Reality show in America. Their American counterparts are responding with union negotiation, layoffs, starting no-frills, low cost airlines among other strategic responses to meet the competitive pressures head on. This paper analyzes the severe threat to the airlines industry in a " pre and post 9/11" global economic perspective to focus on the future of the revamped industry.

INTRODUCTION

The airline industry suffered a major shock in 2001 with the combined forces of global slowdown and the use of commercial aircrafts in a terrorist attack. This has had a huge effect on the industry in terms of a sharp drop in passenger demand, and the forecast is to expect airlines sustaining large losses as the industry deals with the biggest challenge it has faced for a decade. It is too soon to understand the long-term ramification for the structure and shape of the industry, but according to one set of experts these events will make Airline companies relatively more efficient and competitive and will not dent the industry's longer-term growth trend or its economic importance.

Air travel is one of the largest global industries and it continues to have an overall economic impact since it facilitates tourism, world trade, international investment and economic growth, to name a few. Air travel is therefore a vital artery for globalization, as it unfolds in many forms.

After a brief historical introduction to the four American and British airlines being studied in this paper, our attention would turn to financial analyses based on statistics dealing with profitability, leverage, liquidity, income, dividends, long term debt and the like. This would help us judge the financial health of the airline industry and the associated changes with the global setback, to forecast the future of airlines as well as globalization in the fast changing world economy of today.

Besides the negative impact of economic and political events, a stimulus to air travel has been privatization and deregulation of the airline industry, ending the monopolies and protection traditionally enjoyed by state-owned flag carriers and exposing them to the forces of competition. Historical patterns of tight regulations of flight routes are gradually being dismantled, initially in North America and more recently in Europe. This let to the emergence of the 'no-frills' airlines, which have achieved rapid growth in market share in the US domestic and short haul European markets.

AMERICAN AIRLINES

In 1929, Sherman Fairchild created a New York City holding company called the Aviation Corporation (AVCO), combining 85 small airlines to create American Airways. In 1934, E. L. Cord took over and gave the company its present name, American Airlines. After WWII, American bought Amex Airlines, which flew to northern Europe, but a financial crisis prompted Amex's sale in 1950. The airline introduced Sabre, the first automated reservations system, in 1964. In 1980 former CFO Bob Crandall became president. Using Sabre to track mileage, he introduced the industry's first frequent-flier program (AAadvantage). In 1982 American created AMR as its holding company. After acquiring commuter airline Nashville Eagle in 1987, AMR established American Eagle. In the 1980s, AA expanded by buying routes to Japan, Latin America, and London from other carriers. In 1996 AMR spun off nearly 20% of Sabre and announced plans for a code-sharing pact with British Airways that sparked a wave of alliances, including Oneworld, which took effect in 1999. To focus on its airlines, the new president Donald Carty decided to sell AMRs executive aviation services, ground services, and call center units in 1999. Also in 2000 AMR sold its Canadian Airlines stake (bought in 1994) to Air Canada and spun off the rest of Sabre. In 2001 AMR moved to become a stronger competitor to United Airlines (ranked second) by buying the assets of troubled rival TWA for $742 million. AMR, the top USA air carrier, has a fleet of more than 800 jets and operates with hubs in Chicago, Dallas/Fort Worth, Miami, and San Juan, Puerto Rico, and serves about 160 destinations in the Americas, Europe, and the Pacific Rim (some through codesharing). In August 2002 the carrier announced plans to reduce its capacity by 9%, lay off about 7,000 employees, and simplify its fleet by retiring its Fokker-100 jets ahead of schedule. Reuters has reported that American Airlines has hired bankruptcy lawyers in the face of an unprecedented downturn as war with Iraq continues. Reuters sources said the hiring of various firms does not necessarily mean that the airlines are facing imminent bankruptcy , but that "it signals they are keeping options open" as billions of dollars in industry losses continue since September 11.

DELTA AIRLINES

Delta Air Lines was founded in Macon, Georgia, in 1924 as the world's first cropdusting service, Huff-Deland Dusters, to combat boll weevil infestation of cotton fields. In 1928 field manager C.E. Woolman and two partners bought the service and renamed it Delta Air Service after the Mississippi Delta region it served. Delta relocated to Atlanta in 1941. Woolman became president in 1945 and managed the airline until he died in 1966. In 1972 the airline bought Northeast Airlines and added service to New England and Canada; it added service to the UK in 1978. It bought Los Angeles-based Western Airlines in 1986. Delta began service to Asia in 1987; the year Ronald Allen became CEO. In 1990 Delta joined TWA and Northwest to form WORLDSPAN, a computer reservation service. Allen began a cost-reduction plan in 1994 that cut many routes and 15,000 jobs over the next three years. However, it also drove down employee morale and Delta's customer service reputation. In 1996 Delta introduced a no-frills Delta Express but Allen was let go soon after and replaced by Leo Mullin. Later, Delta signed a marketing accord with UAL's United under which the carriers joined their frequent-flier programs. To counter the threat of emerging global alliances Oneworld and Star, Delta announced in 1999 that it would create a competing alliance with Air France and CINTRA's AeroMexico. SkyTeam, which also includes Korean Airlines, was launched in 2000. Domestically, Delta bought regional carriers Atlantic Southeast Airlines and Comair. In the wake of September 11, 2001, Delta cut back its flight schedule and reduced its workforce by about 15% (about 13,000 employees). Delta has launched a budget carrier in 2003 called Song to compete with other low-fare carriers like Southwest and JetBlue.

VIRGIN ATLANTIC AIRWAYS

Freddie Laker launched the Skytrain in 1977, a no-frills carrier flying between London and New York. Rivals eventually cut their fares and drove Laker Airways out of business in 1982. UK lawyer Randolph Fields decided he could succeed where Laker failed. He brought in former Laker executive David Tait and capitalist Richard Branson (whose Virgin Group was emerging as a major media company) to provide capital for a new airline, tentatively named British Atlantic Airways, which came into being in 1983. In the early 1980s, Branson put his fortune and his flare for publicity behind the airline, which was renamed Virgin Atlantic. In 1985 the firm set up Virgin Cargo and Virgin Holidays, a package holiday business. The next year, Virgin Atlantic launched London to Miami service and arranged to buy more jets. This led to additional licenses to fly to Boston (1987), Los Angles (via New York) and Tokyo (1988), and more for a Singapore route (1989). After a settlement and a recovery of an antitrust suit in the US, the airline continued to add routes: Heathrow-Hong Kong (1994) and Heathrow-Johannesburg (1996). A 1995 code-sharing agreement with Delta ended just two years later and was replaced with a similar agreement with Continental. In 2000, Singapore Airlines paid about $960 million for a 49% stake in the airline. After the terrorist attacks on the US soil in 2001, Virgin, who relies on its transatlantic routes, has had to cut back its services on those routes.

BRITISH AIRWAYS

BA has a jet trail going back to 1919 when its predessor named Aircraft Transport and Travel launched the world's first daily international air service between London and Paris. In 1924, British authorities merged Aircraft Transport and Travel successor Daimler Airways with other fledgling British carriers to form Imperial Airways. Competition on European routes emerged in the 1930s from the upstart British Airways. In 1939, the government, troubled by the threat to Imperial, nationalized and merged the two airlines to form British Overseas Airways Corporation (BOAC). After WWII, BOAC continued as the UK's international airline, but state-owned British European Airways (BEA) took over domestic and European routes. In 1972 the government combined the duo to form British Airways (BA). BA and Air France jointly introduced supersonic passenger service in 1976 with Concorde. Colin Marshall became CEO in 1983 and reduced manpower and routes. In 1987 the government sold BA to the public, and the airline bought chief UK rival British Caledonian. BA gained a 25% stake in USAir (which became US Airways) in 1993. It also bought 25% of Qantas. After lawsuits and settlements, Marshall turned over the job of CEO to Bob Ayling in 1996. BA and AA agreed to coordinate prices and schedules and to share market data for their transatlantic routes (Oneworld). In 1997 BA sold its stake in US Airways. Alying resigned in 200, and Marshall stepped in as temporary CEO before Rod Eddington was appointed. Also that year BA took a 9% stake in Iberia and sold its interest in Air Liberte of France. Today, BA flies about 360 aircrafts to nearly 270 destinations in some 97 countries. The threat of hoof-and-mouth disease in the UK and the September 11, 2001 terrorist attacks impacted tourism and BA is working to win back passengers. BA is beefing up its local coverage by moving to an all jet fleet and carrying more than five million passengers a year to 26 destinations in the UK.

FINANCIAL ANALYSIS

In comparing the overall performance of American Airlines, Delta Airlines, Virgin Airways and British Airways, there are certain ratios that are indispensable in aiding with the financial analysis of these companies. Amongst these statistics, we will pay particular attention to their profitability, leverage, and liquidity ratios. Also important would be net income, cash dividends paid-in total, and reduction of long-term debt.

Profitability Ratio: Return On Assets

	12/31/2001	12/31/2000	12/31/1999	12/31/1998	12/31/1997	12/31/1996
American Airlines	-5.73%	4.19%	5.23%	7.13%	6.09%	6.88%
Delta Airlines	-3.95%	6.7%	8.23%	8.69%	8.20%	2.72%
Virgin Airways	2.66%	N/A	N/A	N/A	N/A	N/A
	3/31/2002	3/31/2001	3/31/2001	3/31/2000	3/31/1999	3/31/1998
British Airways	.73%	2.69%	1.61%	3.72%	6.12%	7.28%

Our first indicator of a company's financial health is its return on assets. Return on assets is an indicator of profitability and is determined by dividing net income for the past 12 months by the total average assets, and the result is expressed as a percentage. In analyzing the ROA ratios of the above-mentioned companies, we can begin by discussing American Airlines. American Airlines showed significant profitability in 1996 with a ROA of 6.88%, the subsequent year that percentage decreased slightly to 6.09%; however, in 1998 it grew to a high of 7.13%. In a downturn, which started in 1999, American Airlines experienced decreased ROA for two years, followed by an even more disappointing negative ROA in 2002 of -5.73%.

Its long time competitor Delta Airlines showed minimal profitability in 1996 with a ROA of 2.72%, followed by astonishing successes in later years from 1997 to 2000 with ROAs of 8.20%, 8.23%, 8.69%, and 6.7% respectively. Delta Airlines reached its downturn in 2001, with a negative ROA of 3.95%. This marks a dramatic change from previous years; albeit not as deflated as that of American Airlines.

Virgin Airlines, which does not have data available on ROA before 2000 is the youngest of the above mentioned companies; it finished with an ROA of 2.66%, outperforming both American Airlines and Delta Airlines.

In examining British Airways, we can see a trend present starting in 1998, when its ROA was a profitable 7.28%; the trend is that of diminishing ROA, which culminated in 2002 with an ROA of 0.73%. In comparison to its competitors, British Airways is not fairing all that poorly. Even though its ROA has decreased, it is still positive and outperforming both American Airlines and Delta Airlines.

Another critical determinant of financial soundness is to the liquidity ratio; more specifically we will analyze and compare the current ratio of the above named companies. The current ratio is and indicator of a company's short-term debt paying ability. This ratio is derived by dividing current assets by current liabilities, the higher the ratio, the more liquid the company. Looking at American Airlines we can see that they have been consistent throughout the last six years, their current ratio has fluctuated by not more than 0.16%. They are in a good position in terms of liquidity, with a current ratio in 2001 of .87, however they could stand to focus on elevating that number in the future to ensure that they will remain competitive, as well as to alleviate the concern of becoming insolvent.

Liquidity Ratio: Current Ratio

	12/31/2001	12/31/2000	12/31/1999	12/31/1998	12/31/1997	12/31/1996
American Airlines	.87	.74	.75	.86	.90	.80
Delta Airlines	.56	.61	.5	.73	.7	.9
Virgin Airways	1.09	1.08	N/A	N/A	N/A	N/A
	3/31/2002	3/31/2001	3/31/2001	3/31/2000	3/31/1999	3/31/1998
British Airways	.8	.74	.77	.84	.8	.68

Delta Airlines ended 1996 with an impressive ratio of 0.9, although through the following years they took a hit and were at 0.56 in 2001. This decrease in liquidity is a sign that they are not properly managing their cash flows, and is an indication that if left unresolved they might become insolvent. They must strive to improve this ratio and stay in the range closer to 1.0.

Virgin Airways, reporting data from 2000, shows the highest level of liquidity with a current ratio of 1.09%, which is higher than its competitors. This demonstrates that they are properly managing their cash flows and are able to operate at efficient levels.

British Airways has also managed to keep a consistent trend in terms of liquidity. At the end of fiscal 1997, their current ratio was 0.68%, which was at its lowest rate in the last six years. It has managed to improve its liquidity by 12% to finish with a current ratio of. 8%. There is room for betterment although it is outperforming Delta Airlines and has improved over the years, which is a sign of progress in a turbulent economy.

In examining key financial items, the analysis would focus on comparing the net incomes of American Airlines, Delta Airlines, Virgin Airways and British Airways. Net income is defined as the company's total earnings, reflecting revenues adjusted for costs of doing business, such as depreciation, interest, taxes and other expenses.

American Airlines had a very successful year, reporting a net income of $1.3 billion at year-end of 1999. American Airlines managed to produce an impressive net income of $985 million in 2000 , which was followed in 2001 with a net income of $813 million, yet they could not top the figure for 1999. American Airlines suffered devastating loses as a result of September 11, 2001 and in 2002, they were down by more than $1.7 billion.

Key Financial Items: Net Income (000's $US)

	12/31/2002	12/31/2001	12/31/2000	12/31/1999	12/31/1998	12/31/1999
American Airlines	_1,762,000	813,000	985,000	1,314,000	N/A	N/A
Delta Airlines	-1,216,000	282,000	1,101,000	1,001,000	N/A	N/A
Virgin Airways	117	-59,296	N/A	N/A	N/A	N/A
	03/31/2002	03/31/2001	03/31/2000	03/31/1999	03/31/1998	03/31/1997
British Airways	-202,567	161,473	-33,440	332,795	N/A	N/A

Delta Airlines attained a similarly impressive performance; in 1999 their net income was $1 billion, in 2000 they actually increased their net income by $1 million to close the year with $1.1 billion. In contrast their, net income for 2001 decreased by $800 million over the previous year, leaving them with a year-end net income of $282 million. Comparable to American Airlines; Delta produced negative earnings of $1.26 billion dollars at year end 2002, also attributed to the devastation of September 11, 2001.

In analyzing data for Virgin Airways, we are able to visualize a different trend. Starting with the available data from 2001, we can observe that their net income was negative. They reported a loss of $59 million; compared to the other airlines which were showing positive earnings. However, in 2002 when American Airlines, Delta Airlines, and British Airways were producing negative earnings; Virgin Airways was the only one to actually earn a positive net income of $117,000. Even though $117,000 does not compare to the earnings once obtained in 1999 by American Airlines and Delta Airlines, we should recognize the importance of positively earned amounts as it is of tremendous importance to the financial well being of a company.

British Airways differs from the other companies in several ways. We are able to see that in 1999 the company's net income was $332 million. This is far lower than both American Airlines and Delta Airlines, with a difference of approximately $700 million. The following year British Airways incurred losses and ended 2000 with a net income of -$33 million. These losses differ from American Airlines and Delta Airlines in that these were not directly attributable to September 11, 2001. What is interesting to point out is that while, all three other competitors were experiencing a decrease in their net income, British Airways experienced a substantial increase in their net income; closing the year with over $161 million. Even with their success in attaining a positive net income, they were unable to avoid the comparison associated with September 11, 2001, and they also experienced a loss in net income ending their fiscal year with negative earnings of $202 million. One thing that is evident is that even though British Airways experienced negative earnings, their losses were not of the same magnitude as that of American Airways and Delta Airways; who both lost over a billion each.

Leverage ratios measure the relative value to the stockholders, of capitalization, and creditor obligations, and of the firm's ability to pay financing charges. It is the value of the firm's debt to the total value of the firm, latter being the debt plus the stockholder's capitalization.

Leverage Ratios: Total Debt Of Total Capital

	12/31/2001	12/31/2000	12/31/1999	12/31/1998	12/31/1997	12/31/1996
American Airlines	66.37	46.63	47.59	39.66	41.56	47.34
Delta Airlines	70.03	51.82	36.34	31.29	39.84	45.91
Virgin Airways	-.13	-1.9	N/A	N/A	N/A	N/A
	03/31/2002	3/31/2001	03/31/2000	03/31/1999	03/31/1998	03/31/1997
British Airways	77.49	67.84	68.05	66.67	61.66	61.03

In analyzing the leverage ratio, more specifically the total debt of total capital, we must point out that within the airline industry there is a tendency for the ratio to be high. The reason being that unlike other industries, the airline industry has sizeable startup expenditures, for example when purchasing an aircraft, the expenditure would be comparable to a retail company opening a new manufacturing plant. Also, fuel is an expensive component of the cost to the airline industry and thus contributes to the higher numbers. American Airlines has decreased their total debt of total capital ratio from 1996 to 1998. It signals that in this time period they were decreasing their debt while managing to increase capital, which demonstrates that they were not investing in expansion. In 1999 there was a slight increase, followed by a similar decreasing trend for the next year. In 2001 there was a sizeable jump from 46.63% to 66.37%, demonstrating that American Airlines meant to increase their debt, while at the same time not increasing their equity capital.

Delta Airlines, closely resembles American Airlines in terms of a similar pattern in their leverage ratio. In 1996 they had a ratio of 45.9%, which fluctuated, both up and down, until 2002 when it climbed by more than 20%, which is similar to the strategy of American Airlines in terms of increased expenditures and decreased capital.

Virgin, the newest of these airlines implemented a new strategy differentiating itself from its competitors. In both 2000 and 2001, it had negative percentages, 1.9 and .13 respectively. This leads us to deduce that the company was operating with high debt and negative capital, thus resulting in a negative ratio. This ratio demonstrates Virgin Airways as heavily indebted and not having the capital base required, which can be a dangerous combination.

British Airways follows a similar strategy to that of American Airways and Delta Airways in that its ratio is high, and in actuality, it is higher than both of its competitors. In 1997, British Airways had a ratio almost as high of that of American Airlines in 2001. They seemingly continued to inflate their ratio, as a result of increased debt, in order to expand and to remain abreast of the competition. In 2002, their ratio was 77.49, which is the highest of all four competitors. This indicates that they are heavily indebted when compared to their capital and equity. This could be beneficial if the debt is attributed to growth and expansion; however, the company is in trouble if it is indebted due to poor decisions taken in terms of its investments.

CONCLUSIONS

It is obvious that all airlines had to face major losses since September 11, 2001. However, the financial analysis shows that there are major differences in the level of losses that the aforementioned airlines have suffered. Virgin seems to have survived this major impact on their revenues the best. As a young air carrier, it started with losses and had to face major obstacles in its infancy. During the last two years, however, it came out the strongest among all the other airlines evaluated. It must be mentioned that the study is based on the tragic event of September 11, 2001 resulting in huge losses for the air carriers. British Airways like the other airlines got hit heavily by the terrorist attacks and the global economic slowdown, but the losses are smaller compared to American Airlines and Delta.

It needs to be pointed out that American Airlines and Delta are both American air carriers, whereas Virgin and British Airways originate from England. This implies a dramatic decrease of passenger traffic for domestic flights for American Airlines and Delta whereas British Airways and Virgin might have had a slight decrease in passengers.

Experts believe that the events of September 11 could pave the way for some acceleration in the inevitable and inexorable process of airline restructuring and consolidation. The key issue will be the extent to which favorable cost trends, such as the impact of the internet on distribution costs and cost synergies from industry consolidation, can offset these upward pressures on prices and cost.

The business plan strategies of the airlines depend on several factors. The magnitude and duration of the impact of the terrorist attacks and the economic slowdown in general and the airlines in particular are crucial. In addition, the company's ability to reduce its operating costs and conserve its financial resources will be important. Airlines have to face higher costs associated with the new airline security directives and regulations of air carriers. It also depends on their ability to finance higher costs of aircraft insurance coverage needed for possible future claims caused by acts of war, terrorism, sabotage, hijacking etc. Another important factor to consider is the price and availability of jet fuel, and the ability of the company of hedge its fuel purchases in the current industry conditions. All of these factors are crucial when determining the future outlook of the airline industry.

All airlines responded to the past events by reducing their workforce, operational capacities, capital spending, and routes. To reduce their long-term costs, airlines are changing their pension arrangements for future employees. It has a long way ahead of itself, but with the economy hopefully picking up shortly the airline industry will become more efficient and pass on its cost savings to the consumers.

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